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In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 699

TERRY THOMPSON ET AL., INDEPENDENT EXECUTORS OF THE ESTATE OF J. T. SNEED, JR., DECEASED, PETITIONERS

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 22–35) is reported in 40 B. T. A. 1136. The opinion of the Circuit Court of Appeals (R. 83–90) is reported in 119 F. (2d) 767. Its opinion on petition for rehearing (R. 98–99) is reported in 121 F. (2d) 725.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 5, 1941 (R. 90). A petition for rehearing was denied July 17, 1941 (R. 99). The petition for writ of certiorari was filed October 13, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether where cash bonuses were received by the taxpayer in 1926 for oil and gas leases and a percentage deduction for depletion was allowed with respect to each bonus in computing income for that year, the amount of the allowances may be restored to income in 1936 when the leases expired and were surrendered, no oil or gas having been produced on the properties covered by the leases.

2. Whether where the taxpayer made numerous leases to various lessees covering in the aggregate his entire ranch of 80,000 acres, each tract leased, rather than the ranch as a whole, constituted "the property" the income from which was subject to a percentage allowance for depletion under Section 204 (c) (2) of the Revenue Act of 1926.

STATUTES AND REGULATIONS INVOLVED

The pertinent portions of the statutes and regulations involved are set forth in the Appendix, *infra*, pp. 8–14.

STATEMENT

The facts as found by the Board may be summarized as follows:

The deceased, J. T. Sneed, Jr., was the owner of "Sneed Ranch" consisting of 80,000 acres of land lying in contiguous tracts in the Texas Panhandle Oil and Gas Field (R. 25, 26). In 1926 he made various ten-year commercial oil and gas leases to different individuals and firms, these leases with similar ones theretofore executed covering in the aggregate all of the tracts included within the ranch (R. 25).

Sneed received $210,857.18 in 1926 as cash bonuses for the leases executed that year (R. 25). He reported the bonuses as part of his gross income for the year and, under Section 204 (c) (2) of the Revenue Act of 1926 (Appendix, *infra*, pp. 8–9), claimed deductions for depletion equal to 27½ percent of each bonus received, which were ultimately allowed

after litigation in the Board of Tax Appeals. *Sneed* v. *Commissioner*, 33 B. T. A. 478.

When the leases were made in 1926 there were no oil or gas wells on the tracts involved (R. 25). But the whole of the ranch was regarded as proven oil or gas territory and in the years subsequent to the execution of the leases and prior to 1936 large quantities of oil and some 40 billion cubic feet of gas were taken from various portions of it (R. 25–26). However, on 26 of the tracts, which ranged from 40 to 480 acres in size and were scattered in location, no wells were drilled and no oil or gas was produced (R. 26–27). Accordingly, pursuant to their terms, the 26 leases covering these tracts were surrendered upon their expiration dates in 1936 (R. 26–27).

On account of escape to other tracts and of production on the ranch and elsewhere in the Panhandle Field, the reserves of gas underlying the 26 tracts above mentioned were diminished an average of 11 percent from 1926 to 1936 (R. 27). But commercial quantities of gas remained thereunder and in 1936 after the leases were surrendered Sneed made new leases of the tracts (R. 27). He received cash bonuses in each instance and again was allowed depletion (R. 27).

The bonuses which Sneed received in 1926 on the 26 leases aggregated $120,920.25 and the allowances for depletion $33,528.07 (R. 27). Upon the theory that these allowances should be restored to income, the leases having expired prior to any production under them, the Commissioner included the amount thereof in computing Sneed's gross income for 1936 (R. 24, 27). The Board upheld this action of the Commissioner (R. 29–35). Its decision was affirmed by the court below (R. 90).

ARGUMENT

In *Herring* v. *Commissioner*, 293 U. S. 322, this Court held that production during the taxable year in which cash bonuses are received is not a prerequisite to allowance of the

percentage depletion permitted by Section 204 (c) (2) of the Revenue Act of 1926 (Appendix, *infra*, pp. 8–9). Thus there is no doubt that in 1926 Sneed was entitled to the allowances claimed by him and ultimately granted by the Board.

In its opinion (at p. 328) in the *Herring* case, however, the Court left open the question, here presented, whether the allowances might be treated as income in the year when the leases expire, no oil or gas having been extracted prior to the expiration dates.[1] The Board and the court below answered the question in the affirmative. Although the applicable statutes and regulations are not clear on the point, the interpretation adopted below is, we submit, correct. If the construction urged by the petitioners were adopted, the result would be, in substance, that the benefits of deductions allowed as capital return in anticipation of mineral extraction could be retained notwithstanding that subsequent events proved that there was no extraction and that the deductions represented pure gain.

A. Section 214 (a) of the Revenue Act of 1926 provides for a reasonable depletion allowance to be made under rules and regulations prescribed by the Commissioner, and Section 204 (c) (2) permits computation of the allowance at 27½ percent of the gross income from the property (Appendix, *infra*, pp. 8–9). Article 216 of Regulations 69, promulgated under the 1926 Act (Appendix, *infra*, pp. 11–12) provides in paragraphs (a), (b), (c), and (d) for depletion allowances computed on the basis of cost and for readjustments in capital account in the event of termination, abandonment, or expiration of the lease before removal of any or all the mineral contemplated by the lease. Paragraph (d) specifies that, in such event, "the excess of the depletion theretofore allowable * * * over the actual depletion or loss in value sustained as a result

[1] In view of this fact and of the Court's holding above stated, there is no basis for the petitioners' contention (Pet. 12–13, Br. 44–46) that the decision in the *Herring* case conflicts with that of the court below in the instant case.

of the operations under the lease" shall be restored to capital account, and, in addition, that

> a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

Since these regulations are valid under the statute (see *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, 303–308) and since similar regulations are contained in Article 23 (m)–10 of Regulations 94 promulgated under the analogous provisions of the Revenue Act of 1936 (Appendix, *infra*, pp. 12–13), there can be no question that the restoration to income in 1936 here involved would have been proper, if the allowances had been taken on the basis of cost, rather than percentage. *Lamont* v. *Commissioner*, 120 F. (2d) 996 (C. C. A. 8).

The petitioners contend (Br. 27–31), however, that the foregoing regulations are inapplicable to percentage depletion and that in no circumstances is it required to be restored to income. This contention is based mainly upon paragraph (e) of Article 216 of Regulations 69, which provides:

> In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ percent of the amount thereof, but the deduction shall not exceed 50 percent of the net income (computed without allowance for depletion) from the property.

To construe this language to mean not simply that the lessor may elect to take percentage depletion instead of cost depletion, but that, if he does so elect, he need restore nothing to income upon expiration of the lease without any actual depletion having occurred, would lead to a result never intended by Congress or the Treasury.

In authorizing depletion to be calculated on a percentage basis, Congress permitted a simple method of allowance to be substituted for the complicated previously existing method

of allowance on the basis of cost, but "the nature and the purpose of the allowance is the same in both cases." *Herring* v. *Commissioner*, 293 U. S. 322, 328; *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459, 467. Accordingly, in 1935 after the decision in the *Herring* case, the Assistant General Counsel of the Bureau of Internal Revenue issued an opinion concluding that, as in the case of cost depletion, percentage depletion must be deemed to have been taken subject to the condition that it would be restored to income in the year of termination of the lease where there has been no production from the leased premises. G. C. M. 14,448, XIV–1 Cum. Bull. 98, 100–101, Appendix, *infra*, pp. 13–14.

This opinion, which was followed by the court below (R. 88), is not invalid under the general rule invoked by the petitioners (Pet. 8–12, Br. 32–36) that income is taxable only in the year received or in the year when the right to receive it accrues. In cases of cost depletion (*Lamont* v. *Commissioner, supra*) and in many other circumstances, whether or not provided for by regulations, receipts of one year may be treated as income in a later year under statutory definitions of gross income the same as or similar to those contained in the Revenue Act of 1936 (Secs. 22 (a), 41, 42, Appendix, *infra*, pp. 9–10). *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 353; *Doyle* v. *Commissioner*, 110 F. (2d) 157 (C. C. A. 2), certiorari denied, 311 U. S. 658; *Virginia Iron, Coal & Coke Co.* v. *Commissioner*, 99 F. (2d) 919 (C. C. A. 4), certiorari denied, 307 U. S. 630; and cases cited in the opinion of the court below (R. 89). See *Helvering* v. *Brunn*, 309 U. S. 461. The decision in *Helvering* v. *Schine Chain Theatres*, 121 F. (2d) 948 (C. C. A. 2), is not in conflict with that of the court below since the income there involved should have been taxed in the year received; the only question was whether the taxpayer was estopped to deny liability in the later year. Here it is conceded that Sneed was entitled to the depletion allowances in 1926, subject, however, to the condition above stated.

B. The petitioners contend (Br. 40–44) that Sneed's ranch as a whole was "the property," as meant by Section 204 (c) (2) of the Revenue Act of 1926, in respect of which the percentage depletion was allowed, and that, since there was production on some of the ranch, no portion of the depletion allowed is required to be restored, even if the Government's interpretation of the statutes and regulations otherwise were correct. But Article 221 of Regulations 69 (Appendix, *infra*, p. 12) defines the term as in general referring to "the separate tracts or leases of the taxpayer," and the court below properly ruled (R. 85–86) that each of the 26 leases here involved covered separate property.[2] This Court declined to review an earlier decision to the same effect. *Vinton Petroleum Co.* v. *Commissioner*, 71 F. (2d) 420 (C. C. A. 5th), certiorari denied, 293 U. S. 601, rehearing denied, 293 U. S. 633.

CONCLUSION

The decision of the court below is correct. There is no conflict of decisions. The petition should be denied.

Respectfully submitted.

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NOVEMBER 1941.

[2] The Board (R. 30–33) reached the same result under the definitions contained in Article 23 (m)–1 (j) and (b) of Regulations 94, promulgated under the Revenue Act of 1936.